

# IRS News Release

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## **Remarks of IRS Commissioner Mark W. Everson at the National Press Club in Washington, D.C.**

IR-2005-30, March 15, 2005

WASHINGTON — Thank you, Rick. Thank you all very much. I am pleased to be with the National Press Club again.

I am also pleased to have my wife here, Nanette. We celebrated our twentieth wedding anniversary in December. She has been a great support, particularly these past two years during my service as Commissioner. Last month, Nanette quit her job of three years as the White House Ethics Officer to spend more time with her family. She is probably the only person in America who wants to spend time with the IRS Commissioner.

I would also like to introduce our neighbor, Ed Kahn. Ed is in part responsible for my being here as well. At least for me, becoming IRS Commissioner wasn't something I set out in life to do. The truth be known, like most Americans, what I thought of the IRS probably wasn't all that positive. When we first got to know Ed in the fall of 2001 he told me a number of stories about the IRS from the 1940's and 50's. His respect for the institution was clear and did much to change my view of the IRS for the better. Ed was also one of four original authors of President Eisenhower's legislation that became the Internal Revenue Code of 1954. Ed was 36 years old at the time. In those days people – not special interests – actually wrote the code. And it was a far simpler code. Fifty-one years later, Ed is proof that clean living and simplification lead to longevity! Exactly one year ago today, I stood here and gave you my assessment of our tax administration system. I spoke of the IRS mission of service and enforcement, and about our need to modernize. What I said one year ago was that the IRS was doing a good job improving service, had a mixed record on modernization, and a lot of work to do to restore enforcement to proper levels.

Today I will give you an update on what we've accomplished over the past year, speaking in particular about enforcement, the area where our challenges remain the greatest. I will end with a few points about tax reform.

Let me talk first about our progress in service. By service, we mean helping people understand their tax obligations and making it easier for them to participate in the tax system.

Electronic filing continues to grow. Last year Americans filed 62 million electronic returns. This year we expect that over half of all individual returns will be e-filed. That's correct. Those who file on paper are now in the minority. We take every opportunity we can to trumpet the benefits of electronic filing. E-filing is fast, convenient and gets your refund to you in half the time of paper returns.

Our telephone service – that is, answering questions from taxpayers – continues to improve. Use of our website, [irs.gov](http://irs.gov), is also up sharply. During the filing season, it is one of the busiest websites in the world. We average more than one million visits a day. Just to give you a frame of reference: one major search engine reported that in a recent week we were surpassed only by Paris Hilton, Clay Aiken, Pamela Anderson, Britney Spears, and a poker game. During the past year, we have also rolled out important new on-line services to tax professionals to help them better serve their clients.

In terms of modernizing our big computer systems at the IRS, we've finally turned the corner. Since March 2004, two important systems have started operating. First, we have a new financial system to help better manage the agency. And secondly, and more importantly, for the first in 40 years, the IRS is processing tax returns on a new computer system. We started with 1040EZ returns. This is a big step forward in our effort to modernize our antiquated computer systems.

We are quite aware of the need to operate efficiently, consolidate operations and drive down costs wherever we can. In today's fiscal environment, we recognize that resources are tight. Nevertheless, we are determined to do all we can to improve service and modernize the IRS.

Now let me turn to enforcement of the tax laws.

Since the late 1990s, there has been significant debate about how much enforcement the IRS should carry out. When I spoke a year ago, I think it is fair to say there was still some overhang from the 90's and the Roth hearings that attacked the IRS. There was a view on the part of some that enforcement was a dirty word. But I think that over the past year a consensus has developed that enforcement is an essential function of the IRS. When I meet with Senators, Congressmen, tax professionals and citizens across the country, they frequently ask me, why aren't you doing more? In my two years on the job, few, if any, have suggested we slow down. But, of course, everyone involved in this discussion agrees that as we increase enforcement we must do so with full respect for taxpayer rights.

Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken over the past year to bolster this confidence, turning briefly to each of our four service-wide enforcement priorities.

Our first enforcement priority is to discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals and other contributors to the tax gap.

- In 2004, audits of high income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year – double the number from 2000.
- Overall, audits for individuals exceeded the one million mark last year, up from 618,000 four years earlier.
- In 2004, audits of the largest businesses – those with assets of \$10 million or more – finally turned back up after years of decline.

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high-income individuals. I will touch upon two important initiatives of the past twelve months.

We have started a program of settlement offers for those who entered into abusive transactions in the past but would like to get their problems behind them. Last May, we made a settlement offer regarding the Son of Boss tax shelter, a particularly abusive transaction used by wealthy individuals to eliminate taxes on large gains, often in the tens of millions of dollars. In this program for the first time the IRS required a total concession by the taxpayer of artificial losses claimed. Son of Boss is also the first settlement initiative mandating penalties as a settlement condition. I am pleased with the response to the offer. Next week we expect to make public our Son of Boss results.

Last month we announced a second important settlement initiative – this one involving executive stock options. This abusive tax transaction involved the transfer of stock options or restricted stock to family controlled entities. These deals were done for the personal benefit of executives, sometimes at the expense of public shareholders. This shelter was not just a matter of tax avoidance but in some instances raises basic questions about corporate governance. Again, the settlement offer is a tough one: full payment of the taxes plus a penalty.

A noteworthy point about the stock option settlement offer is that our actions in this matter were closely coordinated with the Securities and Exchange Commission and the oversight board that regulates public accounting firms.

Our settlement initiatives and increased audits have sent a signal: the playing field is no longer as lopsided as it once was. Taxpayers and promoters cannot afford to take an Alfred E. Neuman “What, me worry?” approach to questionable tax shelters. They can no longer assume -- “All I’m putting at risk is the possible payment of the full tax with no penalty.”

Now they might have to pay the entire tax, interest and a stiff penalty. A taxpayer might have to wrestle with questions like “how much am I going to have to pay the lawyers and expert witnesses to litigate this thing?” And going to court is a public matter. Damage to one’s reputation is a potential factor. Many wealthy individuals otherwise seen as community leaders may not want to be identified as paying less than their fair share in taxes.

Another example of cooperation in the battle against abusive shelters is in the international arena. In my speech a year ago, I announced the formation of what has come to be known as the Joint International Tax Shelter Information Centre. Since last Labor Day, we have had an operational task force of personnel from Australia, Canada, the United Kingdom and the U.S. working together on site here in Washington. We are exchanging information about specific abusive transactions. Results to date are promising. Thus far we have uncovered a number of transactions which, but for the Centre, we would have unraveled only over a number of years, if ever. It makes sense that we continue to work with other countries because in this increasingly global world we are up against what is in essence a reinforcing commercial network of largely stateless accounting firms, law firms, investment banks and brokerage houses.

Our second enforcement priority is to assure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law.

Our system of tax administration depends upon the integrity of practitioners. Altogether there are approximately 1.2 million tax practitioners. The vast majority of practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 to restore faith in the work of tax professionals. We have strengthened regulations to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. The IRS standards set forth rules as to what qualifies, and what does not, as an independent opinion about a tax shelter.

Last year the government won a string of court opinions on privilege. The cases established that promoters who develop and market generic tax shelters can no longer protect the identity of their clients by hiding behind a false wall of privilege.

As I pointed out in my speech here a year ago, abusive tax shelters often flourished because penalties were too small. Blue chip tax professionals actually weighed potential fees from promoting shelters but not following the law against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But the speed bumps have become speed traps. Last fall Congress stepped in. Senator Grassley, Chairman of the Senate Finance Committee, has said of the American Jobs Creation Act, "This is the strongest anti-tax shelter measure since 1986." I agree. The Act both creates new penalties and increases existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose monetary penalties not just on tax professionals who violate standards, but also on their employers, firms or other entities if those parties knew or should have known of the misconduct.

Our third enforcement objective is to detect and deter domestic and off-shore based criminal tax activity, our traditional area of emphasis, and related financial criminal activity.

Last year, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year. We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters – both civilly and where warranted, criminally. This is a departure from the past. Previously during a criminal investigation, all civil activity came to a halt. The result was that our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations underway including in the technical tax shelter area. The enforcement model is changing.

Our fourth enforcement priority is to discourage and deter noncompliance within tax exempt and government entities, and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, tax exempt credit-counseling agencies. These organizations get tax exempt status because they are supposed to be educating and assisting people who have credit or cash flow problems. Unfortunately, too many of these organizations instead operate for the benefit of insiders or are improperly in league with profit-making companies. We are carefully scrutinizing these organizations. We currently have half the tax exempt credit counseling industry – in terms of asset size -- under examination.

Some shelter promoters hook up with tax-exempt organizations to create abusive shelters. The organization receives a handsome fee from the taxpayer who is milking its tax-free status. If there are losses, the taxpayer writes them off. Meanwhile, profits from a related transaction are parked with the exempt organization -- which means the profits go untaxed. That is an unintended abuse of the tax exemption that our nation bestows upon charities.

It is heartening to see leading members of the non-profit community taking steps to address abuses. I particularly want to salute the Independent Sector -- which recently delivered a constructive report to the Senate Finance Committee. The report states that "government should ensure effective enforcement of the law" and calls for tougher rules for charities and foundations. The report calls for stronger action by the IRS to hold accountable charities that do not supply accurate and timely public information. Just to note one point, the report supports mandatory electronic filing of all tax returns for non-profits. I wish that the accounting, legal and business communities had been as enthusiastic about confronting abuses and the erosion of professional ethics when corporate governance problems and the proliferation of shoddy tax shelter promotions first became evident.

The threat to the integrity of our nation's charities is real and growing. At the IRS, we take it very seriously. We are augmenting our resources in the non-profit area. By the end of September, we will have increased the number of our personnel who audit tax

exempt organizations by over 30% from two years earlier. If we don't act, there is a risk that Americans will lose faith in our nation's charitable organizations. If that happens, Americans will stop giving and those in need will suffer.

This covers our four enforcement priorities. While we have made progress over the past year, there is much to be done. And we will continue to do it. The Administration has called for a 4.3 percent increase in IRS funding in the President's '06 budget, with a nearly 8 percent increase for enforcement.

These investments will pay for themselves several times over. Last year, the IRS produced direct enforcement revenues of more than \$43 billion from our collection, audit and document-matching efforts. This reflects better than a 4 to 1 return for every dollar invested in the total agency budget, including our service and outreach activities. And our direct enforcement revenues don't include the indirect impact of our work that occurs when a neighbor hears about a friend's audit or reads about a criminal conviction and then spurns the suggestion to inflate a deduction or understate income. Increased enforcement funding makes good sense and contributes to deficit reduction. This year I hope Congress will recognize our unique ability to promote deficit reduction and provide the President's full funding request for the IRS.

Before taking your questions, I want to talk briefly about the tax reform effort the President has launched. My job is to administer the nation's tax system and make sure that the IRS brings in each year the \$2 trillion that funds our Government, and that we do so in a fair and responsible manner without regard to political considerations. As the tax reform process unfolds, I don't expect to offer support for, or to oppose, any particular policy options. On the other hand, the IRS can provide information on how the existing system works, or doesn't as the case may be, as well as offer considerations pertaining to particular policy options based on our unique knowledge of our tax system or other national systems.

Our nation's tax administration system is large and complex. Last year 183 million people filed tax returns – fully half again the number who voted in the Presidential election. The tax system extends beyond activities subject to taxation – such as to important means-tested benefit programs where tens of billions of dollars are paid out. The tax system also has direct links to other vital Governmental activities such as Social Security, Medicare and individual state revenue programs. I mention these considerations in the context of tax reform because statutory changes in one area frequently impact another piece of the overall mosaic.

Let me close with five things to keep mind when reforming the tax code:

- First, our economy is constantly evolving. We have seen the transformation of the workforce to more self-employed individuals; businesses contracting out activities they'd previously done themselves; the rising share of economic growth generated by smaller, non-manufacturing businesses; and increasing globalization. It is vital to construct a tax system that recognizes this dynamic and is built for the 21<sup>st</sup> century, not the 1950s – sorry Ed.

- Second, policy options should be carefully assessed for their potential impact on attitudes towards compliance. Fairness and the perception of fairness are essential, as the President has recognized in his requirement that any proposal be “appropriately progressive.”
- Third, administerability is important. As Ed reminded me just last night, “The law is only good public policy if it can be properly applied.” I would add that bolting new programs on to the tax code without simplifying or eliminating existing elements may make it more difficult to collect the \$2 trillion that funds the Government.
- Fourth, when looking at policy options we must make an apples-to-apples comparison. Don’t compare a sub-optimized existing system to a perfect, theoretical system. I can assure you from my conversations with counterparts in other nations that there are administrative and compliance challenges in all tax systems.
- Finally, we need to recognize that if the transition to a new tax code is not properly planned and managed, the new system will get off to a rocky start. After such a start, it may take decades to recover.

I wish to emphasize that these points are not offered to suggest inaction. That would be perhaps the worst option. I strongly support the President’s call for simplification. Complexity obscures understanding. Complexity in the tax code compromises both the service and enforcement missions of the IRS. Those who seek to comply but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say “why bother.” Meanwhile, promoters of abusive tax shelters hide behind complexity and further weaken the integrity of our tax system. Simplification is an important undertaking. But, of course, as one would expect anyone in my position to say given the enormous stakes for our nation, before moving forward we need to have a high confidence level that the path chosen will lead to success.

Thank you.